IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR KING COUNTY

VONAGE AMERICA, INC., for itself and as a wholly-owned subsidiary of Vonage Holdings Corp. and as successor in interest to Vonage USA, Inc., Petitioner, vs. CITY OF SEATTLE, DIRECTOR OF THE DEPARTMENT OF EXECUTIVE ADMINISTRION, DIVISION OF REVENUE AND CONSUMER AFFAIRS, and CITY OF SEATTLE, OFFICE OF THE HEARING EXAMINER, Respondents.	No. 07-2-15733-6 SEA MEMORANDUM OPINION

THIS MATTER is before this Court on petitioner's Writ of Review regarding the Hearing Examiner's affirmation of the City of Seattle's ("City") tax assessment against Vonage America ("Vonage"). This dispute arises from an audit, conducted by the Director of the Department of Executive Administration, Division of Revenue and Consumer Affairs, of Vonage's records for the period of December 2002 through December 2005 and the resulting tax assessment against Vonage in the amount of $131,435.55. Vonage filed an appeal of the assessment to the Hearing Examiner. On April 30, 2007, the Hearing Examiner denied Vonage's

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appeal and affirmed the tax assessment. On May 14, 2007, Vonage filed this Writ of Review. Vonage challenges the tax assessment as inaccurate for three reasons: (1) Vonage is not engaged in a telephone business, (2) the tax assessment improperly included taxation of interstate activities, and (3) Vonage lacks the requisite nexus to the City of Seattle.

STATEMENT OF FACTS

Vonage provides a service that enables its customers to conduct voice communications via their existing high-speed Internet service using a technology called Voice over Internet Protocol ("VoIP"). To use Vonage's VoIP service, a customer must acquire a "plug-and-play" device from a third-party retailer or directly from Vonage through electronic downloads from its website. Vonage customers are required to provide a valid address for purposes of setting up their account and to be used by emergency response dispatchers in the event they receive a call for assistance from a Vonage customer. Vonage allows its customers to choose any "area code" they wish, even one from an entirely different state than where the customer resides. A Vonage customer may receive or initiate VoIP calls from any computer or location without having to change her number. During the period at issue, Vonage had customers who were Seattle residents that placed and received calls via Vonage's VoIP service.

When a customer initiates a voice communication, the outgoing signal is converted into Internet Protocol digital packets that travel through the Internet to one of three Gateway computers which are located outside of Washington State. The Gateways determine how the digital data packets should be directed and then sends the packets to their destination. If the voice communications are sent to a Vonage customer, the VoIP device of that customer will receive that signal. If the recipient is not a Vonage customer, the digital packets are sent to a

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regional data center located outside of Washington State. The packets are converted to analog signals and sent to the Public Switched Telephone Network ("PTSN"), which sends that signal to a traditional telephone service company that sends the signal to the non-Vonage customer. In Seattle, Vonage purchased these traditional services from WilTel Communications and Global Crossing during the period at issue.

Vonage did not have a Seattle business license during the audit period but is registered with the State of Washington and pays State sales tax. Vonage sells its services in other cities in Washington and, acting through advertising agencies, purchased advertising that was broadcast and circulated in Seattle.

On May 5, 2006, the City issued a final assessment of telephone utility taxes against Vonage for the period of January 1, 2002, through December 31, 2005. The total amount of the assessment is $131,435.55, including all penalties and interest. In making the assessment, the City relied upon a data source that reflected charges to Vonage for traditional land-line calls made by potential and new customers to Vonage's toll-free/customer service number. This invoice resulted in a finding that only three (3) percent of all calls were interstate. Another invoice from WilTel Communications to Vonage, that Vonage contends is more accurate, was not received or used by the auditor due to problems in transmitting the invoice electronically.

On June 16, 2006, Vonage filed an appeal of the assessment to the Hearing Examiner, and a hearing was held on February 7, 2007. At the hearing, Vonage presented an internal study of five WilTel invoices that estimated interstate calls near eighty (80) percent. On April 30, 2007, the Hearing Examiner issued her Finding and Decision in the Matter of Appeal of Vonage

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from a B&O Tax Assessment, which denied Vonage's appeal and affirmed the tax assessment. On May 14, 2007, Vonage filed this Writ of Review.

STANDARD OF REVIEW

Vonage brought this matter before the court under a Writ of Review. The standard of review for the resultant special proceeding is governed by RCW 7.16.120. This court must review the Hearing Examiner's application of law de novo in finding "[w]hether, in making the determination, any rule of law affecting the rights of the parties thereto has been violated to the prejudice of the relator." RCW 7.16.120(3).

The Hearing Examiner's findings of fact are reviewed by this court as to "[w]hether the factual determinations were supported by substantial evidence." RCW 7.16.120(5). The review is deferential, viewing the evidence and reasonable inferences therefrom in the light most favorable to the City, "the party who prevailed in the highest forum that exercised fact-finding authority." *Washington State Dep't of Corrections v. City of Kennewick*, 86 Wn. App. 521, 534, 937 P.2d 1119 (1997), *rev. denied*, 134 Wn.2d 1002, 953 P.2d 95 (1998).

DECISION

1. Vonage is engaged in a telephone business.

Vonage argues that it does not meet the definition of a telephone business and, therefore, should not be subject to the telephone utility tax. The enabling statute, and the subsequent taxing statute, was written broadly to encompass the various and many types of telephonic businesses. "Telephone business" was defined during the period at issue as:

> [T]he providing by any person of access to a local telephone network, local telephone network switching service, toll service, cellular or mobile telephone service, coin telephone service, pager service or the providing of telephonic, video, data, or similar

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> communication or transmission for hire, via a local telephone network, toll line of channel, cable, microwave, or similar communication or transmission system.

SMC 5.30.060.C. The Hearing Examiner concluded that Vonage provided access to a local telephone network in providing access to the PTSN for calls made to telephone numbers in the traditional telephone network. This conclusion is supported by the Hearing Examiner's finding that Vonage relies on access to PTSN, purchased from WilTel Communications and Global Crossing during the period at issue, for sending calls made by Vonage customers to non-Vonage customers. To the extent that Vonage customers were provided access to PTSN, those calls would be subject to taxation under the statute because Vonage is clearly providing access to a local telephone network.

Interpretation of a statute is a question of law that this court will review de novo. *Western Telepage, Inc. v. City of Tacoma Dept. of Financing*, 140 Wn.2d 599, 607, 998 P.2d 884 (2000) ("*Western Telepage*"). Although the Hearing Examiner stated that telephone business is defined broadly "and includes the voice communication services that Vonage provides[,]" she did not clearly define the words "telephonic" and "similar communication," or explain how those definitions apply to VoIP services. When terms are not defined by statute, as here, the court turns to their ordinary dictionary meaning. *Western Telepage*, 140 Wn.2d at 609. "*Webster's* dictionary defines 'telephonic' as 'conveying sound to a distance[.]'" *Id*. VoIP services convert analog sound signals into digital packets that are sent over an Internet connection to gateway computers that, in turn, direct the packets to their destination be it the PTSN or another Vonage customer's computer. While Vonage wiring may not be the means of conveyance, Vonage has a hand in the conveyance of the sound at many points of the voice communication service and earns profit from such service, as the Hearing Examiner pointed out. Even if arguably this

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process does not fit squarely within the definition of "telephonic", it is remarkably "similar communication" to the process of sending traditional telephone calls to the PTSN.

The phrase "any person" indicates inclusive intent, as does the following terminology: "or the providing of telephonic, video, data, or *similar communication* or transmission for hire[.]" SMC 5.30.060.C (emphasis added). The plain language of the statute clearly states that communication of telephonic services or *similar communication* for hire is sufficient. As described above, Vonage's VoIP services are, or are remarkably similar to, telephonic communication. Therefore, Vonage is subject to the telephone utility tax because its services meet the definition of a telephone business under SMC 5.30.060.C.

Vonage attempts to apply the words of the statute selectively by saying that transmission is required. Citing *Community Telecable of Seattle, Inc. v. City of Seattle*, 136 Wn. App. 169, 149 P.3d 380 (2006), *rev'd on other grounds*, --- P.3d ----, 2008 WL 2522728 (Jun 26, 2008) ("*Community Telecable*"), Vonage argues that the pertinent verb of SMC 5.30.060.C, is "to transmit." In *Community Telecable*, at the appellate level, Comcast attempted to exclude itself from the telephone utility tax by arguing that it was an internet service; however, the court found that Comcast's data transmission was subject to the telephone utility tax. Vonage argues that this meant that data transmission is integral when taxing a telephone business. However, nothing in the appellate court's opinion could be construed to suggest that the telephone utility tax ordinance required a telephone business "to transmit" to be subject to taxation, only that transmission was one possible factor in determining why Comcast should be subjected to the telephone utility tax.

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The Washington State Supreme Court's recent reversal of the *Community Telecable* Court of Appeals decision contradicts Vonage's reading of the telephone business definition. "Under our holding, a telephone business offering Internet services [including transmission] cannot be charged a telephone tax for those services, but may still be charged a telephone tax for providing telephone services[.]" *Community Telecable*, No. 79702-1 (June 26, 2008). The court held that data transmission for the purpose of delivering Internet service could not be taxed under the telephone business definition; however, telephone services offered by the same company would be subject to taxation. Therefore, transmission is not the essential factor considered by the Washington State Supreme Court. Rather, the providing of telephone service is the integral factor as to whether a city may impose a telephone tax.

In response, Vonage argues that it provides Internet services, not telephone services, because it uses rather than provides telecommunications services and should be excluded from taxation. Vonage relies on *Vonage Holdings Corp. v. Minn. Pub. Utilities Comm'n*, 290 F. Supp. 2d 993, (D. Minn. 2003), *aff'd*, 394 F.3d 568 (8th Cir. 2004) ("*Vonage Holdings*"), where the court, considering Vonage's motion for a preliminary injunction, found that Vonage's services in that state were likely to be considered preempted by the FCC as information services that used telecommunications services. However, the holding in *Vonage Holdings* has been applied in a limited fashion. While the appeal was pending, the FCC issued *In Re Vonage Holdings Corp.*, 19 F.C.C.R. 22404 (Nov. 12, 2004) ("*Vonage Preemption Order*"). In that Order, the FCC relied on the impossibility exception in preempting state regulation of Vonage's VoIP services but expressly declined to delineate the information services-telecommunications distinction, leaving it for state determination or later FCC orders. Subsequently, the Minnesota Department of

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Revenue in Revenue Notice # 05-03 specifically stated that "VoIP is a telecommunications service" subject to Minnesota sales and use tax. This reflects that the decision in *Vonage Holdings* did not affect the right of a city in Minnesota to tax VoIP services as telecommunications.

Additionally, Vonage does not need be a telecommunications company to be taxed as a telephone business by the City. Vonage argues that the language of the statute, SMC 5.48.050.A, contains an ambiguity that suggests that only telecommunications businesses can be considered telephone businesses. Vonage may be correct that an ambiguity exists; however, the ambiguity is whether the exception, "tax liability imposed under this section shall not apply for that portion of gross income derived from charges to another telecommunications company," can apply only to telecommunications companies or more broadly to telephone businesses. SMC 5.48.050.A. In *Qwest Corp. v. City of Bellevue*, 161 Wn.2d 353, 166 P.3d 667 (2007) ("*Qwest*"), the court held that the phrase "another telecommunications company" in RCW 35A.80.060, a statute that is similarly worded to SMC 5.48.050, was not intended to limit or affect the prior statutory language. "[T]he statute's legislative history supports the conclusion that [the statute] precludes city taxation of charges for interstate service regardless of whether those charges are to another telecommunications company." *Qwest*, 161 Wn.2d at 368. Similarly, just as the phrase "another telecommunications company" does not affect charges for interstate service, the phrase should not affect the complete definition of telephone business. Regardless, that ambiguity is not relevant to the issues in this case and need not be elaborated on further.

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2. Vonage's services are not interstate by law. However, the Hearing Examiner's findings regarding the ratio of intrastate to interstate use are not supported by substantial evidence.

Vonage argues that VoIP services are interstate as a matter of law and should be excluded from city taxation. More specifically, Vonage argues that its VoIP services should be considered exempted by the "question of law" language in *Qwest* or under the jurisdiction of the FCC and not be subject to city taxation.

Vonage claims that the court in *Qwest* held that the determination of whether a service, such as Vonage's VoIP service, was interstate or intrastate was a legal question and not based on the use of the service. However, a close reading of the case reveals a narrower holding. In *Qwest,* the court was posed the following question: whether an FCC tariff that requires an initial declaration of whether charges are interstate or intrastate can be modified by a state court after use of the charged service is determined to be different than the initial declaration. The court found that the initial declaration of expected use determined proper jurisdiction over the charged service, and that jurisdiction did not change because of how the charged service was actually used; such use was immaterial as a matter of law to the question posed.

The *Qwest* court's rather narrow holding did leave an unanswered question that is pertinent to this case: whether services not subject to an FCC tariff that have an interstate component are excludable from state taxation by law or simply subject to discount for any interstate use? Vonage argues that the reasoning behind the *Vonage Preemption Order* - that VoIP is difficult (if not impossible) and inefficient to divide accurately into interstate and intrastate use - should also apply to city taxation. However, in contrast to its regulatory preemption, the FCC has *not* asserted jurisdiction over city taxation of Vonage's VoIP services.

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In the *Vonage Preemption Order*, the FCC stated that it made no opinion regarding state or local taxation of Vonage; rather, the FCC focused exclusively on jurisdiction over VoIP services for purposes of regulation, such as certification or other related requirements as conditions to offering VoIP services in that state. This is consistent with the FCC's general position on VoIP services:

> [T]he FCC is giving the VoIP industry a lot of time to develop, free from many of the regulatory obligations applied to traditional telecommunications services. This approach is consistent with the Commission's previously-stated reluctance to regulate the nascent VoIP industry for fear of hindering its development. At the same time, the Commission has found a mechanism to satisfy its statutory obligations under Title II with respect to consumer protections and public health and safety concerns. The FCC cleverly has imposed select Title II obligations by using Title I ancillary (and discretionary) authority without having to declare VoIP to be an information service. By taking this approach, bit by bit over time, the FCC may make the question of regulatory classification somewhat irrelevant. Perhaps the FCC is waiting for VoIP to effectively replace traditional circuit-based telephony before imposing all Title II obligations. Regardless, as of today, many unresolved questions remain for VoIP providers, such as intercarrier compensation issues, and state and federal tax issues. For the time being, the FCC's incremental approach toward VoIP regulation probably will be the norm.

Will the FCC Ever Make the Call on VoIP Service?, 25-FALL Comm. Law. 4, 6 (2007). That incremental approach is currently directed towards issues besides taxation. "[I]n the *IP-Enabled Services Proceeding*…we anticipate addressing other critical issues such as universal service, intercarrier compensation, section 251 rights and obligations, numbering, disability access, and consumer protection[.]" *Vonage Preemption Order*, 19 F.C.C.R. at 22432. Thus, the FCC's stated position is that city taxation of VoIP services is not among the critical issues at this juncture.

As the FCC has not asserted jurisdiction over city taxation of VoIP services, the City maintains jurisdiction over taxation of VoIP services sold to Seattle residents and must apply its own reasoning to determine whether VoIP services should be excluded from taxation or subject

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to discounted tax based on interstate use. Plainly, the City asserts, by assessing a telephone utility tax against Vonage, that VoIP services should not be considered interstate in total. Where an agency is charged with the administration and enforcement of a statute, the agency's interpretation of an ambiguous statute is accorded great weight in determining legislative intent. *Dot Foods, Inc. v. Department of Revenue, State of Wash.*, 141 Wn. App. 874, 884, 173 P.3d 309 (2007) (citations omitted). Nonetheless, reviewing courts must also consider the legislative intent. "If the statute is ambiguous, the courts must construe the statute so as to effectuate the legislative intent." *Id*., citing *Whatcom County v. Bellingham*, 128 Wn.2d 537, 546, 909 P.2d 1303 (1996). The plain language of the enabling statute, RCW 35.21.714, allows any Washington State city to tax one hundred (100) percent of total gross revenue derived from intrastate telephone services. Under this language, any time that a Vonage customer in Washington State calls another person in Washington State such revenue may be taxed by a city with jurisdiction to do so. The legislature intended to enable cities' ability to broadly tax intrastate telephone services, limited only by the language of the statute following the word "PROVIDED". When a business provides both intrastate and interstate telephone services, as Vonage does, it cannot be denied that the legislative intent was to allow taxation of those services which are intrastate. Without federal preemption, Vonage is bound to the legislative intent in promulgating RCW 35.21.714: all telephone businesses that are not subject to federal preemption, regardless of whether they have an interstate component, can be taxed on those services which are intrastate.

Thus, because this court finds that Vonage's VoIP services are not interstate by law, this court must determine whether the Hearing Examiner's findings regarding the ratio of interstate to

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intrastate use in the tax assessment are supported by substantial evidence. SMC 5.55.140.B states that "[t]he Director's assessment or refund denial shall be regarded as prima facie correct, and the person shall have the burden to prove that the tax assessed or paid by him is incorrect, either in whole or in part, and to establish the correct amount of tax." The Hearing Examiner properly determined that a tax assessment is prima facie evidence, and that the burden was on Vonage to prove the assessment was incorrect. Vonage met that burden, as the Hearing Examiner states, by presenting evidence that shows "the August 2005 WilTel invoice used by the department to estimate interstate service revenues was not related to the use of service by Vonage's customers. Thus, the assessment may be inaccurate[.]" Therefore, the tax assessment was no longer prima facie correct. Next, the Hearing Examiner held that the Code placed the burden on Vonage to establish the correct amount of tax, and that the invoices and traffic study provided by Vonage did not reflect the correct interstate use to be discounted from the intrastate assessment. At first glance, the Hearing Examiner should be sustained in regards to the fact that Vonage did not present sufficient evidence of the "correct tax."

However, to sustain these findings would level a tax assessment against Vonage that would include charges for interstate activity. The invoice that the City used to determine the ratio of interstate to intrastate calls had nothing to do with use of the VoIP service; rather, it was related to calls made to Vonage's customer service number. The record is unsupported by substantial evidence that Seattle Vonage customers only use the service to contact people outside of Washington State three-percent of the time. Such a tax assessment would be in violation of the exception to telephone business taxation outlined in RCW 35.21.714: "PROVIDED, That the city shall not impose the fee or tax…for access to, or charges for, interstate services[.]"

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Therefore, this court must reconcile the findings of the Hearing Examiner with the limiting exception in RCW 35.21.714.

In Washington State, the phrase "prima facie correct" has not been explored at length or with regard to the conflict presented here. Nevertheless, this court finds that it cannot be construed in a manner to grant greater authority to the City than the enabling statute allows. RCW 7.16.120(2) requires a court in a special proceeding to determine "[w]hether the authority, conferred upon the body or officer in relation to that subject matter, has been pursued in the mode required by law, in order to authorize it or to make the determination." In assessing the taxes applicable to a telephone business, the Seattle Department of Executive Administration is enabled and limited by RCW 35.21.714. When an assessed party rebuts the prima facie correctness of the assessment by showing that the assessment was outside the scope of assessor's authority (RCW 35.21.714), the assessor must present evidence of how the assessment can be modified to comport with applicable law. Only then can the burden shift back to the assessed party for a showing of the "correct tax."

Upon remand, the City must show by substantial evidence that the taxes being assessed are for intrastate services only. When the City has established an authorized tax, the burden of establishing the "correct tax" then shifts back to Vonage. If the City cannot establish an authorized tax, the Hearing Examiner must reverse the assessment. However, this court is persuaded by the following statement made by the auditor during cross-examination that an authorized tax can be established: "And if it was necessary to allow them an interstate deduction even though they are bundling it together, I do see how we could use something like that [traffic] study."

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3. Substantial evidence of a nexus between the City of Seattle and Vonage exists to allow the City to exact taxation based on engagement in a telephone business.

Vonage argues that Seattle lacks the requisite nexus to properly tax Vonage's VoIP services. The law and facts support the opposite conclusion. In *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987) ("*Tyler Pipe*"), the court held that the "crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe*, 483 U.S. at 250. Vonage advertises in Seattle, sells software and other items to Seattle residents, and purchases the right to use telephone lines in Seattle. That Vonage has engaged in sufficient activities to establish and maintain a market in Seattle for a sufficient nexus to exist is supported by substantial evidence.

Vonage argues that the United States Supreme Court has found that taxation of a business requires a substantial nexus with the state, and that the nexus requires physical presence in the state. *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992) ("*Quill*"). However, as noted by the Hearing Examiner, the court in *General Motors Corp. v. City of Seattle*, 107 Wn. App. 42, 25 P.3d 1022 (2001), made clear that the *Quill* physical presence requirement does not apply to business and occupation taxes assessed in Washington State. The City's authority to tax telephone businesses is governed by the definitions section of the business and occupation tax under RCW 82.04.065. Sufficient evidence exists to support a finding that a substantial nexus exists between Vonage and the City because physical presence is not required for business and occupation taxation; therefore, Vonage is subject to the telephone utility tax.

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CONCLUSION

For the foregoing reasons, the findings of the Hearing Examiner in regards to the amount of the tax assessment are VACATED and this case is REMANDED for further proceedings consistent with this opinion.

Date this 18th day of July, 2008.

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